Effective January 1, 2008, the Michigan Single Business Tax is repealed and replaced with the Michigan Business Tax ("MBT"). Entities other than insurance companies and financial institutions are subject to the MBT which is comprised of two components (1) a modified gross receipts tax and (2) a business income tax. While the Single Business Tax is imposed on a separate company basis (that is only if the company is doing business in Michigan), the MBT is imposed upon a unitary group of entities even if the entity is not doing business in Michigan.

The following summarizes some of the key provisions of the modified gross receipts tax and explains the issues the modified gross receipts tax poses to the financial services industry.

Modified Gross Receipts Tax

- Unitary groups are subject to a modified gross receipts tax and a business income tax.
- The modified gross receipts tax rate is 0.8% and the business income tax rate is 4.95%.
- A group of U.S. persons that are engaged in a unitary business must file a combined report. A "unitary business group" is a group of U.S. persons if one of the persons owns or controls, either directly or indirectly, more than 50% of the ownership interests, determined by voting rights, and that has business activities which result in a flow of value between or among the persons included in the unitary business group.
- Modified gross receipts tax base means gross receipts less "purchases from other firms."
    - Purchases from other firms includes (i) inventory, and (ii) assets that are or will become eligible for depreciation, amortization or accelerated cost recovery for Federal income tax purposes.
    - Inventory includes (i) the stock of goods held for resale in the regular course of trade of a retail or wholesale business, including electricity and natural gas purchased; (ii) finished goods, goods in process and raw materials of a manufacturing business purchased from another person and (iii) for a person that is a new motor vehicle dealer, floor plan interest expenses for new motor vehicles. "Floor plan interest" means interest paid that finances any part of the person's purchases of new motor vehicle inventory from a manufacturer, distributor, or supplier.
    - There are a number of receipts that are specifically excluded from the definition of "gross receipts." Many of the items are limited to industries other than the financial services industry.
- Modified gross receipts of a unitary group is the sum of the modified gross receipts of each member of the group less gross receipts arising from intercompany transactions.
- Tax on modified gross receipts is imposed at a rate of 0.8% upon the combined group's modified gross receipts tax base after applying the combined group's sales factor.

<u>Issues With the Modified Gross Receipts Tax</u>

- The failure of the modified gross receipts tax to exclude from the definition of "purchases from other firms" the cost of securities and commodities as defined in the Internal Revenue Code Section 475 (c)(2), and (e)(2)(B), (C) and (D) and the cost of capital to acquire securities and to borrow funds for lending activities yields an unfair and disproportionate result to the financial services industry.
    - A typical dealer in securities and commodities incurs an extremely high rate of turnover in positions and generally earns a very small profit margin on transactions.
        - <u>Example</u> – it is common for a dealer to acquire a position for $99.90 and subsequently sell that position for $100, resulting in a profit of ten basis points.
            - The Gross Receipts Tax would be based on the $100.
    - Furthermore, there may be no correlation between the gross receipts of a financial services provider and its profitability
        - The volume of business activity, measured by gross receipts, does not necessarily translate to the amount of taxable income generated.
    - A typical dealer enters into numerous transactions in securities, commodities, and non-physical transactions in commodities, such as forward contracts. Like the securities business, non-physical transactions in commodities are high volume and low margin. Therefore, the inclusion of gross receipts from securities and non-physical commodities transactions without an offset of tax basis produces a distortive result due to the low profit margin. Therefore, "purchases from other firms" should be expanded to include, for broker/dealers and their affiliates, "securities" and "commodities" as defined in IRC Section 475(c)(2) and (e)(2)(B), (C) and (D).
- The modified gross receipts tax allows a new motor vehicle dealer a deduction for interest expense incurred as a cost of capital. That is, "floor plan interest" is included in the definition of "inventory" and thus is a reduction from gross receipts in the computation of modified gross receipts.
    - The financial services industry should be allowed a similar deduction for interest expense incurred as a cost of capital to both acquire "securities" and to borrow funds for lending activities, such as reverse repurchase agreements, margin lending and stock borrow transactions.
- For a sales finance company, as defined in Section 2 of the motor vehicles sales finance act, 1950 (Ex Sess) PA 27, MCL 492.102, and directly or indirectly owned in whole or in part by a motor vehicle manufacturer as of January 1, 2008, gross receipts does not include the principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
    - The current law excludes from gross receipts the principal portion of loans. While we believe that repurchase agreements and other similar financing transactions engaged in by financial services firms are loans, as they are treated as such for Federal income tax purposes, we believe that this

provision which specifically references repurchase agreements and other financing transactions should be extended to the financial services industry. Financial services firms engage in numerous financing transactions similar to a sales finance company. The failure to extend this exclusion from gross receipts for the principal amount received under a repurchase agreement or other transaction characterized as a loan to the financial services industry results in inconsistent treatment of companies engaged in lending transactions.

- For a sales finance company, as defined in Section 2 of the motor vehicles sales finance act, 1950 (Ex Sess) PA 27, MCL 492.102, and directly or indirectly owned in whole or in part by a motor vehicle manufacturer as of January 1, 2008, gross receipts does not include amounts realized from the repayment, maturity, sale, or redemption of the principal of a loan, bond, or mutual fund, certificate of deposit, or similar marketable instrument.
    - This provision should be extended to the financial services industry for instruments that are not held as inventory. Financial services firms engage in numerous financing transactions similar to a sales finance company. The failure to extend this exclusion from gross receipts for amounts realized from the repayment, maturity, sale or redemption of the principal of a loan, bond, or mutual fund, certificate of deposit, or similar marketable instrument results in inconsistent treatment of companies engaged in lending transactions.
- Due to the magnitude of the transactions for a financial services firm, it is unlikely that an alternative apportionment methodology would cure the distortive effect of Gross Receipts tax.

Example of Distortive Effect of Modified Gross Receipts Tax:

The following example compares the tax a multistate financial services firm would pay under the current modified gross receipts tax with the modified gross receipts tax that the same firm would pay if the firm was treated in a similar manner to an automotive manufacturer.

Assume Financial Services Firm XYZ, a multistate filer, does business in Michigan and is a member of a unitary group that has a Michigan sales factor of .25 %. The combined group's Federal taxable income is $3 billion.

Modified Gross Receipts Tax – Current Law

Gross Receipts from Principal Trades	$11,400,000,000,000	
Gross Receipts from Reverse Repurchase Agreements	$ 13,500,000,000	(Note 1)
Other Gross Receipts of the Unitary Group	$ 45,000,000,000	(Note 2)
Modified Gross Receipts	$11,458,500,000,000	
Combined Group's Apportionment %	0.25%	(Note 3)
Gross Receipts Tax Rate	0.80%	
Modified Gross Receipts Tax	$ 229,170,000	(Note 4)

Modified Gross Receipts Tax – Financial Services Firm Treated Similar to Automotive Manufacturer

Gross Receipts from Principal Trades	$11,400,000,000,000	
Gross Receipts from Reverse Repurchase Agreements	$ 13,500,000,000	(Note 1)
Other Gross Receipts of the Unitary Group	$ 45,000,000,000	(Note 2)
Total Gross Receipts	$11,458,500,000,000	
Less Purchases From Other Firms:		
Cost of Securities	(11,388,600,000,000)	
Interest Expense on Financing Transactions	(12,500,000,000)	
Modified Gross Receipts	$ 57,400,000,000	
Combined Group's Apportionment %	0.25%	(Note 3)
Gross Receipts Tax Rate	0.80%	
Modified Gross Receipts Tax	$ 1,148,000	(Note 5)

Distortion: As the above example illustrates, a financial services firm would pay a gross receipts tax that is **200 times greater** than the tax that would be paid by a manufacturer on similar receipts. Accordingly, we request that technical corrections be made as discussed above so that financial services firms are treated in a manner similar to manufacturers and other lending institutions.

Note 1: We have assumed that the principal amount received under a repurchase agreement or other transaction characterized as a loan for Federal income tax purposes would not be a taxable gross receipt. This amount represents the gross interest income earned on reverse repurchase agreements or other instruments characterized as a loan.

Note 2: This number represents all other gross receipts of "unitary" members and includes entities that are not doing business in Michigan. This number is after exclusions for intercompany transactions.

Note 3: This number assumes a "Finnigan" approach. That is, the numerator of the fraction includes Michigan sales of all members of the unitary group regardless of whether or not the member has nexus with Michigan.

Note 4: This tax would be in addition to the tax on business income. Assuming that business income for the unitary group is $3 billion and the combined apportionment factor is 0.25%, then the tax on business income would be $371,250 ($3 billion times .25% apportionment x 4.95% tax rate). The total tax for the unitary group would be $229,541,250.

Note 5: This tax would be in addition to the tax on business income. Assuming that business income for the unitary group is $3 billion and the combined apportionment factor is 0.25%, then the tax on business income would be $371,250 ($3 billion times .25% apportionment x 4.95% tax rate). The total tax for the unitary group would be $1,519,250.

Thus, the needed technical corrections that would be limited to a broker or dealer or a person that is a futures commission merchant and any person affiliated with such persons include

(1) modification of the definition of inventory to include the cost of securities and the cost to acquire securities and to borrow funds for lending transactions i.e., interest expense. This is similar to the inclusion in inventory of "floor plan expense;"
(2) define "securities" and "commodities" by reference to IRC Section 475(c)(2) and (e)(2)(B), (C) and (D);
(3) expansion of Sec. 111(q) to a "broker," "dealer," "futures commission merchant" and affiliates for instruments that are not held as inventory. This provision excludes from gross receipts amounts realized from the repayment, maturity, sale or redemption of the principal of a loan, bond or mutual fund, certificate of deposit, or similar marketable instrument. Since financial services firms engage in numerous financing transactions similar to sales finance companies, similar treatment should be afforded to financial services firms; and
(4) expansion of Sec. 111(r) to a "broker," "dealer," "futures commission merchant" and affiliates. The MBT does exclude from gross receipts the principal portion of loans. While we believe that repurchase agreements and other similar financing transactions engaged in by financial services firms are loans, as they are treated as such for Federal income tax purposes, we believe that this provision which specifically references repurchase agreements and other financing transactions should be extended to the financial services industry.